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No. 08-916

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IN THE
Supreme Court of the United States

VFJ VENTURES, INC., F/K/A VF JEANSWEAR, INC.,
Petitioner,

v.

G. THOMAS SURTEES, IN HIS OFFICIAL CAPACITY AS
COMMISSIONER OF THE DEPARTMENT OF REVENUE
FOR THE STATE OF ALABAMA, AND THE
ALABAMA DEPARTMENT OF REVENUE,
Respondents.

**On Petition for a Writ of Certiorari
to the Supreme Court of Alabama**

REPLY BRIEF OF PETITIONER

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REPLY BRIEF

Petitioner VFJ Ventures, Inc. ("VFJ"), and its amici (including the State of Delaware) have shown that certiorari should be granted because the Alabama Supreme Court's decision upholding the Alabama add-back statute conflicts with this Court's decisions on two issues of recurring and nationwide importance. First, the Alabama add-back statute violates the Commerce Clause because it discriminates against interstate transactions by denying a deduction to VFJ because it pays royalties to related Delaware corporations. Pet. 13-19. Second, the add-back statute violates this Court's "fair apportionment" standards because it attributes income to Alabama based not on VFJ's activities in Alabama, but on the tax policies of a sister State. *Id.* at 20-25. Lastly, VFJ and its amici explained the pressing need for this Court to resolve the constitutionality of the Alabama add-back statute. *Id.* at 25-31; Delaware Br. 11-14. Alabama has no answer.

Remarkably, Alabama neither acknowledges nor attempts to respond to the amici brief filed by the State of Delaware, which showed that review should be granted because the add-back statute discriminates against interstate commerce in a manner that undermines Delaware's economic development policies. Delaware Br. 6-7, 11-14. The conflict between the positions of two sovereign States by itself justifies immediate review because the Commerce Clause was designed "ke[ep] to a minimum" "[r]ivalries among the States," *Granholm v. Heald*, 544 U.S. 460, 472 (2005), and thus to avoid "economic Balkanization." *Hughes v. Oklahoma*, 441 U.S. 322, 325-26 (1979).

On the merits, the State admits that if the Alabama add-back statute provides preferential treatment for transactions that occur "entirely within Alabama" over those that take place across state lines, then "it would indeed violate well-established constitutional norms." Opp. 14. That admission is dispositive because, under Alabama's law, VFJ's royalty payments to Lee and Wrangler were not deductible from its Alabama income, but those same payments would have been deductible if Lee and Wrangler were located in Alabama or another State that shares Alabama's tax policies. The effect of that discrimination was to increase VFJ's annual Alabama tax liability "by slightly over \$1 million" simply because Lee and Wrangler are located in Delaware, rather than Alabama. *Id.* at 15.

The State cannot justify this discrimination by arguing that the add-back statute "preserv[es] for a business some of the tax advantage" of locating Lee and Wrangler in Delaware. *Id.* at 16 (emphasis added). To the contrary, the Commerce Clause prohibits Alabama from enacting discriminatory laws that "stri[p] away" any of the "the competitive and economic advantages" that Lee and Wrangler offer VFJ by virtue of their location in a State with a more favorable tax policy. *Hunt v. Wash. State Apple Adver. Comm'n*, 432 U.S. 333, 351 (1977); accord *Healy v. Beer Inst., Inc.*, 491 U.S. 324, 339 (1989). As Delaware explains, the add-back statute violates the Commerce Clause because it "attempt[s] to nullify the benefits that Delaware has chosen to grant as

part of its carefully considered tax policy.” Delaware Br. 7.¹

As to fair apportionment, the State argues that VFJ’s position “misses the mark so widely” that it does not “know how to respond.” Opp. 19. The tax treatise upon which the State relies, however, clarifies any confusion. It explains, relying on *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), that where, as here, an add-back statute results in “extraterritorial taxation of income properly attributable to other states,” there is “a substantial argument that the add-back statute, as applied, violates fair-apportionment principles.” 1 J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 7.17[3][d], at S7-17 to -18 (3d ed. 2008).

Finally, the State insists that the Court should “wait” until there are additional decisions addressing the constitutionality of the other add-back statutes from across the country. Opp. 31. That is incorrect. Immediate resolution of the questions presented is important (i) to corporate taxpayers who are being subjected to substantial, unconstitutional tax burdens, (ii) to add-back States, which may eventually have to pay out massive refunds retrospectively, and

¹ The State attempts to divert attention from this conclusion by challenging the legitimacy of VFJ’s royalty payments. Opp. 4-11. That discussion is baseless. The trial court found that (i) VFJ’s royalty payments to Lee and Wrangler “have economic substance and business purpose” and (ii) there are multiple business reasons apart from tax planning “for segregating the ownership and management of its trademarks into [Lee and Wrangler].” Pet. App. 67a, 74a-75a. The Alabama appellate courts did not disturb these findings and ruled that the add-back statute was not even intended “to address the issue of sham or fraudulent transactions or deductions.” *Id.* at 36a-37a.

(iii) to States like Delaware, which may “well suffer irreparable harm” if companies decide that “the benefits of [their] tax polic[ies] are too uncertain to justify organizing” there. Delaware Br. 12.

VFJ’s petition should be granted.

I. THE ALABAMA ADD-BACK STATUTE IS CONTRARY TO THIS COURT’S COMMERCE CLAUSE AND DUE PROCESS CLAUSE PRECEDENTS.

1. The State of Alabama essentially concedes both the controlling law and the dispositive facts that demonstrate that Alabama’s add-back statute discriminates against interstate commerce in violation of the Commerce Clause.

First, the State admits that this Court has “consistently struck down state tax measures that discriminated against interstate commerce either facially, or in their practical effects.” Opp. 13 (citations omitted). Second, the State agrees that if its add-back statute “resulted in such differential treatment benefiting in-state activities or entities, it would indeed violate well-established constitutional norms.” *Id.* at 14; see, e.g., *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996). Finally, the State concedes that VFJ’s royalty payments to Lee and Wrangler subjected VFJ to an additional Alabama tax liability of “slightly over \$1 million,” per year (Opp. 15)—a liability that VFJ would have avoided if Lee and Wrangler were located in Alabama or in another State that shares Alabama’s taxing policies. The Alabama add-back statute is a textbook example of legislation that impermissibly discriminates against interstate commerce. See, e.g., *New Energy Co. of Ind. v. Limbach*, 486 U.S. 269, 274 (1988).

The State's only response is to argue that there is no discrimination because Alabama's "add-back statute disfavors, rather than rewards, businesses that locate a portion of their holding company activities in Alabama." Opp. 16. It does no such thing. As to Petitioner VFJ, the only entity subject to Alabama income tax, the add-back statute imposes more than \$1 million in additional taxes because VFJ pays royalties to related entities in Delaware rather than in Alabama. The add-back statute plainly disfavors interstate commerce.

Further, the State is wrong when it argues that the Alabama add-back statute does not discriminate against interstate commerce because if Lee and Wrangler were relocated to Alabama, then the combined Alabama tax liability of Lee, Wrangler, and VFJ would "sharply increase." *Id.* at 15. Even assuming that the State's calculations were accurate, the reason that relocation of Lee and Wrangler to Alabama would "sharply increase" their Alabama tax liability is not because the Alabama add-back statute "disfavors" Alabama, but because Alabama taxes royalty income and Delaware does not. That difference in tax policy provides Delaware with what it believes is a competitive advantage over other States such as Alabama. Alabama's add-back statute is a discriminatory effort by Alabama to "strip[] away . . . the competitive and economic advantages" that Delaware and other States have made available. *Hunt*, 432 U.S. at 351; accord *New Energy*, 486 U.S. at 275. As the State of Delaware cogently explains, the Alabama add-back statute (and the nearly 20 others like it) violate the Commerce Clause because they seek to "nullify the benefits that Delaware has chosen to grant as part of its carefully considered tax policy." Delaware Br. 7.

Lastly, the discrimination against interstate commerce would not be cured even if, as the State claims, the add-back statute had the effect of "preserving for a business some of the tax advantage of locating the holding company" in a State with favorable tax policies. Opp. 16 (emphasis added). To the contrary, "the magnitude and scope of discrimination have no bearing on the determinative question whether discrimination has occurred." *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 650 (1994).

Review should be granted because the Alabama add-back statute violates the Commerce Clause by attempting to "deprive businesses . . . in other States of 'whatever competitive advantages they may possess' based on the conditions of the local market." *Healy*, 491 U.S. at 339.

2. Review also should be granted because the Alabama add-back statute violates this Court's fair-apportionment standards.

The State of Alabama argues that it had trouble responding because VFJ's position is so wide of the mark. Opp. 19. The Hellerstein treatise, which the State cites repeatedly, takes a conflicting view. According to that treatise, where, as here, a taxpayer's royalty payments have "economic substance" and the add-back statute results in "extraterritorial taxation of income properly attributable to other states," application of the add-back statute "might well . . . violate[] fair apportionment principles." 1 Hellerstein, *supra* ¶ 7.17[3][d], at S7-17 to -18. Alabama's add-back statute does indeed violate fair apportionment principles because it results in the taxation of VFJ without regard to any "reasonable sense of how income is generated." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

Alabama argues that fair apportionment is not implicated because the add-back statute is “unrelated” to Alabama’s otherwise permissible three-factor apportionment formula. Opp. 19-20. That argument misses the point. The Alabama add-back statute determines whether *any* of the royalty income VFJ paid to Lee and Wrangler should be treated as income of VFJ subject to Alabama’s three-factor apportionment calculation in the first place. See *Container Corp.*, 463 U.S. at 163-65 (discussing the “unitary business/formula apportionment method” as a whole); cf. *Trinova Corp. v. Mich. Dep’t of Treasury*, 498 U.S. 358, 373-79 (1991) (applying fair-apportionment principles to review inclusion of items in tax base subjected to three-factor apportionment formula).

Contrary to Alabama’s claim (Opp. 21-23), VFJ properly relied on *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), when it showed that the add-back statute violates the fair-apportionment prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). VFJ invoked *Hunt-Wesson* because it applied the leading fair-apportionment case—*Container Corp. of America v. Franchise Tax Board*, which held that a State’s apportionment method must “actually reflect a reasonable sense of how income is generated.” 528 U.S. at 466 (quoting *Container Corp.*, 463 U.S. at 169). *Hunt-Wesson* thus stands for the proposition that the Constitution restricts a State’s ability to subject a multistate entity’s income to taxation based on a factor unrelated to how the income is generated. *Id.* That applies four-square to this case because the add-back statute denies VFJ a deduction, and thereby apportions more income to Alabama, based on a factor that does not reflect how VFJ generates

income—i.e., the tax policy of a sister State. Because Delaware's tax policy says nothing about VFJ's activities in Alabama, it should not affect VFJ's tax liability in Alabama.²

Nor does VFJ's position remotely "contradict[] the Court's holding in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937)," Opp. 24-25, or call into question tax credits for taxes paid in another State, *Id.* at 11. In *Henneford*, the Court upheld a tax on the privilege of using tangible personal property within the State. The statute exempted the use of any article that had already been subjected to a sales tax equal to the use tax or greater, so that the use tax effectively applied only to goods purchased out of state. 300 U.S. at 579-81. Although the use tax was facially discriminatory, the combined effect of the sales and use taxes subjected interstate and intrastate commerce to equivalent burdens. *Id.* at 584. Here, the Alabama add-back statute has nothing to do with sales or use taxes, but rather the determination of taxable income, to which this Court has applied an entirely different set of principles. *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 186 (1995).

Alabama's reference to personal income tax credits (Opp. 11, 26-27) fails for a similar reason: Such credits are available to a *taxpayer* that paid income

² Alabama errs in arguing that this Court's fair-apportionment cases bar only grossly distorted apportionment results. Opp. 23-24. A State's apportionment method must also bear a reasonable relationship to the taxpayer's activity "on its face," *Norfolk & W. Ry. v. Mo. State Tax Comm'n*, 390 U.S. 317, 325 (1968), and cannot be "inherently arbitrary." *Hans Rees' Sons, Inc. v. N.C. ex rel. Maxwell*, 283 U.S. 123, 130 (1931) (quoting *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-21 (1920)); see also Pet. 23-24 & n.6 (collecting cases).

tax in a sister State, thereby avoiding double taxation and reflecting that the taxpayer had income-earning activities outside the State. In stark contrast, the add-back statute operates with regard to whether *non-taxpayers* (Lee and Wrangler) paid income tax, and thus the add-back statute neither prevents double taxation of VFJ nor reflects anything about how VFJ generated income. As such, the add-back statute is invalid. See *Hunt-Wesson*, 528 U.S. at 466.

II. REVIEW IS WARRANTED BECAUSE THE CASE SQUARELY PRESENTS ISSUES OF SURPASSING NATIONAL IMPORTANCE.

By asking this Court to “wait” for other state court decisions on add-back statutes (Opp. 28), Alabama seriously downplays the importance of this Court’s nondiscrimination principles, and also the harms that delay would cause to taxpayers and States alike.

Because “even the smallest scale discrimination can interfere with the project of our Federal Union,” this Court has reviewed claims of state discrimination against interstate commerce even when the statute had limited scope or existed in a *single* State. *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 595 (1997). Review is needed here all the more because *many* States have adopted similar add-back statutes with broad effect, extracting millions of dollars in unconstitutional taxes each year. See Pet. 27 n.7. Indeed, since VFJ filed its petition just weeks ago, yet another State has enacted a provision extending add-back requirements to royalty payments.³ Impermissible discrimination on such

³ 2009 Wisconsin Act 2, § 76 (codified at Wis. Stat. § 71.01(5n), which extends scope of existing add-back provisions at Wis. Stat. § 71.05(6)(a)24, (b)46, to include royalty payments made to a

grand a scale warrants this Court's immediate attention.

Further, the direct conflict between two States addressed in this case is reason enough for this Court's review. Yet, Alabama does not even acknowledge Delaware's participation in this case. Delaware has designed its corporate income tax policies to attract intangibles management companies—and the high-wage, high-skill jobs they offer. Delaware Br. 5. Rather than compete with Delaware on permissible terms, Alabama (and other States) have sought to negate Delaware's policies and discourage taxpayers from outside Delaware from dealing with Delaware companies. As a result, unless this Court intervenes, companies will have constitutionally suspect incentives to reconsider their decisions to locate in Delaware, or to choose not to locate there in the first place. Delaware, in turn, may try to change its tax policies to counter the add-back statutes. See *id.* at 13. The add-back statutes thus foment the very rivalries that the Commerce Clause is intended to prevent. See *Granholm*, 544 U.S. at 472.⁴

related member; subject-to-tax exception codified at Wis. Stat. § 71.80(23)(a)2).

⁴ Contrary to Alabama's claim (Opp. 28-30), the questions presented here were fully briefed and preserved below. Before the Alabama Supreme Court, VFJ's briefs led off with the federal constitutional challenges and devoted more than 20 pages to them. VFJ Ala. Sup. Ct. Br. 25-34; VFJ Ala. Sup. Ct. Reply Br. 6-18. Alabama responded fully to the constitutional questions presented here. State Ala. Sup. Ct. Br. 17-36. And the opinion adopted by the Alabama Supreme Court adopted a detailed (albeit erroneous) analysis of the court of appeals addressing both of the issues presented here. See Pet. App. 50a-64a. Add to that the trial court's comprehensive factual findings

The uncertainty surrounding add-back statutes poses serious problems, with high stakes, for taxpayers and States alike. Alabama's attempt to discount those concerns falls flat. It comes as no surprise that the lawyers representing clients actually affected by the add-back statute are among those expressing concerns. Opp. 30. Moreover, Alabama's attempt to downplay the importance of this case is belied by the multiple pages it spends describing the prevalence of intangibles holding companies and the substantial tax revenues in play. *Id.* at 1-4.

Finally, not only taxpayers but also States would benefit greatly from this Court's review. If the decision below is left unreviewed, Alabama and nearly 20 other States will continue collecting taxes through the add-back statute that will likely be subject to refund when the statutes are eventually invalidated. Accordingly, this Court should intervene now and provide needed resolution for all parties affected by add-back statutes.⁵

(*id.* at 65a-77a), and it is hard to imagine what more could be "developed."

⁵ Alabama also claims that review is unwarranted because, in its view, the subject-to-tax exception could be severed from the add-back statute. Opp. 32-33. But the availability of severance is premature because it remains unclear whether any aspect of the add-back statute survives a constitutional challenge. See *Okla. Tax Comm'n*, 514 U.S. at 185. In any event, because severance is an issue addressed only after the constitutional challenge is resolved, it poses no barrier to review.

CONCLUSION

For these reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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